

City of Detroit

CITY COUNCIL

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ANNE MARIE LANGAN
DEPUTY DIRECTOR
(313) 224-1078

TO: COUNCIL MEMBERS

FROM: Irvin Corley, Jr., Director *ICJ.*

DATE: February 17, 2010

RE: Responses to Questions on Resolution Extending Interest Rate Swap Agreements Associated with Outstanding and Future Sewage and Water System Bonds *(Line Item 14 on Today's Budget, Finance and Audit Committee Calendar)*

As a reminder, your Honorable Body approved a resolution during last week's formal session extending interest rate swap agreements associated with outstanding and future water and sewage bonds. By approving this resolution and extending these agreements to July 1, 2013, the City Council avoided the City having to make a potential one-time termination payment of up to \$93 million to the swap counterparties.

But for Council's edification, the Finance Department responded to questions one through six of our memorandum regarding this issue. The first attachment represents Finance's responses, and the second attachment represents our memo. We are satisfied with these responses, as they help to educate your Honorable Body and the Fiscal Analysis Division on the unique arena of interest rate swap transactions.

However, Finance has yet to respond to questions seven, eight and ten. Question nine is no longer applicable given that your Honorable Body approved the resolution. In addition, it is obvious that had not Council approved the resolution; the imminent termination payment of \$93 million would have had an adverse impact on water and sewerage rates.

We would appreciate getting responses to questions seven, eight and ten in two weeks.

Attachments

cc: Council Divisions
Auditor General's Office
Norman White, Chief Financial Officer

Donita Crumpler, General Manager-Finance
Pamela Scales, Budget Director
Kamau Marable, Mayor's Office

ICJ:\CORLEY\Responses to Interest Rate Swap DWSD Questions 2010.doc

1. Please explain how the city came to the conclusion in 2003 that swap agreements would be a good thing for controlling costs in the DSWD capital programs?

At that time, interest rates were historically low with an expectation that they could increase in the future. An increase would result in higher borrowing costs on planned bond transactions. The City decided that it was advantageous to lock in the low interest rate for future borrowing by entering into forward starting swaps. Having a known interest rate would also allow the Detroit Water and Sewerage Department "DSWD" to effectively budget and plan rate increases to accommodate future debt service.

2. How many swap agreements have we had like this, and what has been the outcome for each of them? Please list all existing swaps.

In addition, to the forward starting swaps listed above, on May 22, 2003 the City entered into four forward starting swaps that are listed below:

	Water System Forward Starting Swaps		Sewer System Forward Starting Swaps	
Counterparty	Morgan Stanley	Morgan Stanley	Morgan Stanley	Morgan Stanley
Original Notional	\$195,000,000	\$120,000,000	\$137,500,000	\$125,000,000
Swap Rate	4.347%	4.532%	4.407%	4.547%
Effective Date	July 1, 2005	September 1, 2006	September 1, 2005	December 1, 2006
Termination Date	July 1, 2035	July 1, 2036	July 1, 2035	July 1, 2036
Status	Terminated	Terminated	Terminated	Terminated

These swaps were terminated on September 9, 2003 and DWSD received a payment in the approximate amount of \$31 million, which were used for capital projects. A list of outstanding swaps is attached.

3. For the specific swap extensions currently before Council, how much have we paid? Does the payment change each month? Sometimes is the city getting paid?

Because they have not yet become "effective", DWSD has not paid anything on these swaps except for certain legal and consulting costs to initiate the transaction. In order to accomplish the extension, the swap rate on the Morgan Stanley swaps will increase by approximately 88 basis points (as of January 12, 2010) but no progress payments are required. In regards to the SBS Financial swaps, the interest rate will remain the same but DWSD will make monthly progress payments in the estimated amount of \$340,000.

4. Why didn't we sell bonds during this time period -2006 to 2010? What if we don't sell bonds before it expires again? What are the chances that the MDEQ financing will come through at a better rate, again, thereby the city holding on to this swap for a locked interest rate and not using it?

DWSD capital improvement program is probably more dynamic now than at any other time over the past 20 years, including the time these swaps were entered into, due to the uncertain status of the major projects mentioned below, DWSD efforts to ensure that only "mission critical" infrastructure investments are being made during this economic slump, and the uncertainty regarding the extent of State Revolving Fund ("SRF") monies available to DWSD. Below we list specific reasons on why the System has not sold bonds between 2006 to 2010:

- The cornerstone projects in the capital improvement programs have been delayed. The large water pipeline "loop" was put on hold due to a stretch of low demands and to accommodate service negotiations with customers in the northern part of the service area, including Flint and Genesee County. The large sewer CSO projects were put on hold to re-evaluate the environmental project benefits relative to the costs.
- The City secured \$200 million in State Revolving Fund loans to finance other sewer projects – mitigating the need to sell sewer revenue bonds in the public markets.

- As a result, capital funds are on hand and projected to be sufficient to finance planned capital improvements through at least June 30, 2011.
- This could change depending on developments impacting the cost and schedule of the cornerstone projects mentioned above.

While it appears likely that bonds will be required before July 1, 2013, if not, the City will analyze its options at that time and determine the optimal course of action which may include a request for a further extension.

5. If the swap turns in the city's favor, is the plan to cash it in, even without selling bonds?

The City will continually monitor the value of the swaps and, if the swap turns into the City's favor would consider terminating the swap as it did for the swaps mentioned above.

6. So the current choices the city has are the following: 1. extend the swap through 2013, with council authorization and continue to monitor the swap; 2. sell bonds before the expiration date of the swap and roll the cost into bond sale; 3. allow the swap to expire and currently the city would owe \$93 Million. Is that correct??

Yes.

SWAP TABLE @ 6/30/09

Associated Financing Issue	Notional Amounts (1)	Effective Date	Swap Termination Date	Final Maturity of Bonds	Counterparty
Sewage 1998-A	\$ 67,500,000	07/01/08	07/01/23	07/01/23	JPMorganChase
Sewage 1998-B	67,500,000	07/01/08	07/01/23	07/01/23	JPMorganChase
Detroit Building Authority Series 1999-A	\$ 25,800,000	10/22/99	07/01/29	07/01/29	Citigroup
Water 2001-C	113,070,000	06/07/01	07/01/26	07/01/26	Morgan Stanley
Water 2001-C Mirror Swap	113,070,000	05/14/08	07/01/26	07/01/26	Morgan Stanley
Sewage 2001 C-2	123,340,000	10/23/01	07/01/29	07/01/29	UBS
Sewage 2001 C-2 Mirror Swap	123,340,000	05/08/08	07/01/29	07/01/29	UBS
Sewage 2001 D-2	72,450,000	07/01/12	07/01/32	07/01/32	Loop/ Deutsche
Water 2003-B	14,250,000	01/30/03	07/01/09	07/01/09	Morgan Stanley
Water 2003-C	4,335,000	01/30/03	07/01/13	07/01/13	Morgan Stanley
Water 2004-A	77,010,000	07/01/05	07/01/25	07/01/25	JPMorganChase
Water 2004-B	158,490,000	07/01/05	07/01/23	07/01/23	JPMorganChase
Water 2005-B	195,000,000	04/01/05	07/01/35	07/01/35	Morgan Stanley
Water 2005-B Mirror Swap	195,000,000	05/06/08	07/01/35	07/01/35	Morgan Stanley
Water 2006-B	120,000,000	05/17/09	07/01/36	07/01/36	Morgan Stanley
Water 2006-B Mirror Swap	120,000,000	04/01/09	07/01/36	07/01/36	Morgan Stanley
Sewage 2006-A	125,000,000	08/10/06	07/01/36	07/01/36	Loop/ Deutsche
Sewage 2006-A Mirror Swap	125,000,000	05/07/08	07/01/36	07/01/36	Loop/ Deutsche
Sewage 2006-D	361,315,000	12/14/06	07/01/32	07/01/32	UBS
Sewage Hedge Swap (2)	56,250,000	03/01/10	07/01/39	N/A	SBS/Merrill
Sewage Hedge Swap (2)	168,750,000	03/01/10	07/01/39	N/A	Morgan Stanley
Water Hedge Swap (2)	150,000,000	03/01/10	07/01/39	N/A	Morgan Stanley
Water Hedge Swap (2)	50,000,000	03/01/10	07/01/39	N/A	SBS/Merrill
Water Hedge Swap (2)	76,510,000	07/01/11	07/01/29	N/A	SBS/Merrill
Water Hedge Swap (2) Mirror Swap	76,510,000	07/01/11	07/01/29	N/A	SBS/Merrill
Pension Obligation Certificates-GRS-FGIC	96,621,000	06/12/06	06/15/34	06/15/34	SBS/Merrill
Pension Obligation Certificates-PFRS-FGIC	153,801,500	06/12/06	06/15/34	06/15/34	SBS/Merrill
Pension Obligation Certificates-PFRS-Syncora	104,325,500	06/12/06	06/15/29	06/15/29	SBS/Merrill
Pension Obligation Certificates-GRS-Syncora	45,252,000	06/12/06	06/15/29	06/15/29	SBS/Merrill
Pension Obligation Certificates-GRS-FGIC	153,801,500	06/12/06	06/15/34	06/15/34	UBS
Pension Obligation Certificates-PFRS-FGIC	104,325,500	06/12/06	06/15/29	06/15/29	UBS
Pension Obligation Certificates-PFRS-Syncora	96,621,000	06/12/06	06/15/34	06/15/34	UBS
Pension Obligation Certificates-GRS-Syncora	45,252,000	06/12/06	06/15/29	06/15/29	UBS

1. Notional amount balance as of June 30, 2009

2. Denotes that the associated bond issue has not been issued as of the balance sheet date; issued in anticipation of a future planned variable rate bond issue.

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Budget, Finance & Audit
Standing Committee
Referred to Committee: 2-16-10
LINE ITEM# 14 Date: 2-17-10
Disposition _____

(313) 224-1078

TO: Councilmembers

FROM: Irvin Corley, Jr., Director *ICJ*
Anne Marie Langan, Deputy Director *AML*

DATE: February 5, 2010

RE: Resolution Amending and Supplementing a Prior Resolution
Approving Transactions Under Certain Interest Rate Exchange
Agreements Entered into in Connection with Related Outstanding
and Future Sewage System Bonds of the City of Detroit and
Related Outstanding and Future Water System Bonds of the City of
Detroit.

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At last week's Budget Finance and Audit Committee, there was a line item from the Finance Department asking that Council authorize a resolution extending a swap resolution that had initially been approved by Council on April 7, 2006 for a period through March 1, 2010. The extension that is requested is through July 1, 2013. It was requested by Councilmember Brown that this office provide a written explanation on this issue.

Currently it is the advice of the Finance Department that the best option for the city right now is to extend the swap agreement. If Council chooses not to extend the swap agreement, it would expire. However at this time the swap instrument is not in the city's favor and therefore if terminated the city would owe a payment of \$93 million. The city will not owe this amount at this time if the extension is granted.

Attached for your review are pages 110 through 114 of the most recently completed Comprehensive Annual Financial Report (CAFR) of 2008 that was just completed in December 2009. These pages explain the city's position of interest rate swaps. The city is currently part of 32 individual interest rate swaps. The four that relate to this report are the ones for Sewage and Water that are circled.

At the time the city entered into these swaps in 2006, the explanation relayed to our office was that DWSD had a significant capital program that would continually need additional bonding, the interest rates were close to 6% and by entering into this swap agreement, the interest rate would be at 4.93%. After this agreement

was in place, DWSD was granted the ability to sell bonds for capital projects through the Michigan Department of Environmental Quality (MDEQ) and the interest rate was 2.5%, which was even more favorable. This is why this option was not used and now the city is in the position of needing to extend it.

We have submitted the following questions to Finance and are expecting responses soon:

1. Please explain how the city came to the conclusion in 2003 that swap agreements would be a good thing for controlling costs in the DWSD capital programs?
2. How many swap agreements have we had like this, and what has been the financial outcome for each of them? Please list all existing swaps and what we have to pay for them.
3. For the specific swap extensions currently before Council, how much have we paid? Does the payment change each month? Sometimes is the city getting paid? Is this swap a different type of swap from the swap entered into for the POCs?
4. Why didn't we sell bonds during this time period -2006 to 2010? What if we don't sell bonds before it expires again? What are the chances that the MDEQ financing will come through at a better rate, again, thereby the city holding on to this swap for a locked interest rate and not using it?
5. If the swap turns in the city's favor, is the plan to cash it in, even without selling bonds?
6. So the current choices the city has are the following: 1. Extend the swap through 2013, with council authorization and continue to monitor the swap; 2. Sell bonds before the expiration date of the swap and roll the cost into bond sale; 3. Allow the swap to expire and currently the city would owe \$93 Million. Is that correct?

Below are some additional questions that we would like responses to:

7. How many municipalities enter into these types of agreements, and is it still prudent for the city to continue this policy? Can you show us the analysis performed that presented this as the fiscally responsible method of rate setting?
8. On page 178 of the 2008 CAFR there is a SWAP Termination Fee from 2006 of \$38 million. Please explain what this is.
9. If the Council were to vote no on this resolution extending this swap agreement, how would this affect water and sewerage rates?

10. What is the new administration's position on this swap policy?

It seems that it has been known for some time that this swap was going to need an extension. The administration should explain why this resolution, which is quite a complex financial instrument, would come before Council just weeks before it is to expire. Especially after the crisis of the swap agreements that were in place because of the POCs, it would seem logical that Council would require a more in depth explanation of the situation. We would recommend that the Finance Department prepare a written report explaining the swap policy and how it benefits the city's finances.

We appreciate the Finance Department's request that Council authorize this resolution. We think that it would benefit everyone for Council to see the responses to the above questions prior to voting.

Attachments

cc: Council Divisions
Auditor General
Norman White, Chief Financial Officer
Tom Lijana, Finance Director
Donita Crumpler, Debt Manager